BEFORE THE ARIZONA CORPORATION COMMISSION

KRISTIN K. MAYES
CHAIRMAN
GARY PIERCE
COMMISSIONER
SANDRA D. KENNEDY
COMMISSIONER
PAUL NEWMAN
COMMISSIONER
BOB STUMP
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS ELECTRIC, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	Docket No. E-04204A-09-0206

RESIDENTIAL UTILITY CONSUMER OFFICE'S ("RUCO") INITIAL CLOSING BRIEF

The Residential Utility Consumer Office ("RUCO") hereby submits its Closing Brief on the matters raised in UNS Electric's, Inc.'s ("UNSE" or "Company") recent rate hearing.

TABLE OF CONTENTS

I. INTRODUCTION

In or about April of 2009, UNSE filed a rate application requesting an increase in revenues of $13.5 million. UNSE-1 at 1.[1] The test year that the Company utilized in this case was the twelve months ending December 31, 2008. Id. at 2-4. RUCO recommends an increase of $4,604,908. Final Schedule BJ-1. Staff recommends an increase in revenues of $7,830,901. Staff Final Schedule THFA-1 at 1. The big issue in this case concerns pre-approval by the Commission of rate base treatment for the costs associated with the Black Mountain Generating Station ("Black Mountain" or "BMGS"). RUCO and the Company believe that the Commission should approve the Company's revenue neutral request to rate base Black Mountain. Staff believes that the Commission should not allow the Company to rate base Black Mountain because the Company has not acquired ownership of Black Mountain. RUCO understands and is sympathetic to Staff's concerns, but for the reasons more fully set forth below, RUCO believes the situation is unique and it would be in the ratepayers best interests for the Commission to approve rate base treatment of the BMGS.

Most of the Company's other recommendations in this case where there is disagreement are attempts by the Company to get approval for adjustments and/or methodologies that were rejected by the Commission in the Company's last rate case or in other utility rate cases. RUCO continues to urge the Commission to deny these requests unless the Commission feels the record supports it and something has changed since the previous Commission Decisions or the Company has presented a persuasive reason for change. RUCO has not been persuaded by any of the Company's arguments that the Commission should change its position from what it previously has done. The outstanding

---

[1] For ease of reference, trial exhibits will be identified similar by their identification in the Transcript of Proceedings. The transcript volume number will identify references to the transcript.

issues and the issues where there is no disagreement or where RUCO has not taken a position are as follows.

II. CONTESTED RATE BASE ISSUES

Plant-In-Service

Black Mountain Generation Station

The Company's unregulated affiliate, UniSource Energy Development Company ("UED"), owns a 90 MW gas turbine generating facility in northern Arizona known as BMGS. RUCO-6 at 15. In 2008, UED and the Company signed a 5-year Purchase Power Agreement ("PPA") under which UED sells all of its output from BMGS to the Company. Id. BMGS consists of two combustion turbines which UED acquired at a discount. Id., RUCO – 1 (Decision No. 70360) at 74. The Company's proposal here is similar to its proposal in its last case – that UED transfer BMGS to the Company at a cost of $62 million, and that the Commission approve a post-test year adjustment to the Company's rate base and a revenue neutral rate reclassification reflective of the cost of the facility. RUCO-6 at 16. The Commission should approve the Company's proposed ratemaking treatment of the BMGS.

The Company's proposal closely parallels its request in its last rate case. However, in the last rate case, the Company's affiliate, UED, had not built the plant and its construction, operating and maintenance costs were not known. RUCO-1 at 74-75. At the time, RUCO and Staff opposed rate base treatment of BMGS because neither the capital costs nor the operational costs were known. Id. at 76. RUCO was concerned that ratepayers would be required to pay for the plant prior to its completion and prior to a prudency review of the plant costs. Id. The Commission denied the Company's request to allow rate base treatment of the plant in the last case, but encouraged the Company to acquire BMGS. Id. To provide encouragement, the Commission authorized an accounting order to allow the Company to record all of its financial activities associated with BMGS. Id. The Commission also approved the Company's request for up to $40 million of new debt financing and up to $40 million from an equity infusion from UniSource Energy for the purpose of acquiring BMGS. Id. at 78.

Since its last rate case, UED has built the plant and it is operational. BMGS entered service on May 30, 2008. UNSE-8 at 13. Its construction and operational costs are known. Id. at 16. From RUCO's perspective, most of the issues that were the subject of the last rate case no longer are a concern.

Staff, however, opposes the Company's proposed ratemaking treatment in this case. According to Staff, the "Company does not own BMGS now, so it should not be included in rate base as a post test year plant in service adjustment even if it is subsequently transferred from UED to UNSE." S-9 at 55. Staff makes a good point. It is not the normal regulatory accounting practice to rate base plant that is not owned by the utility.

RUCO is sympathetic to Staff's argument and agrees that the normal regulatory accounting practice is appropriate 99 percent of the time. But this is not the normal situation – the Company does not have sufficient cash flow to service the additional capital required to purchase BMGS. UNSE-13 at 5. The Company has made it clear that "Absent a post-test year adjustment to rate base and the proposed revenue-neutral rate reclassification, an acquisition of the BMGS is simply not feasible from a financial perspective." Id. The Company's point is persuasive – as of December 31, 2008, the Company's total capitalization was $192 million. UNSE-3 at 15. The Company was and still is not in a position to acquire a $62 million asset without a "…commensurate increase in earnings and cash flow." Id. The Commission's prior rate case decision allowing the Company to defer its costs, while generous, did nothing to provide the Company with sufficient cash flow relief to cover the interim cash costs that the Company would incur to finance the BMGS acquisition. Id.

Furthermore, it would not have been prudent for the Company to attempt to finance the plant since its last rate case. Had the Company financed the plant with a large amount of debt, it is likely that its Baa Moody's rating would have slipped below investment grade. Transcript at 159. The problem was further enhanced by the fact that the Company in 2008 had completed a private placement financing transaction and had $60 million in notes coming due. Transcript at 161. Because of other capital additions that were previously made, there was another $40 million in debt in addition to the $60 million making a total of $100 million coming due. Id. To now seek another $40 million for BMGS could surely place the Company's credit rating in peril. Id. The cost of additional BMGS debt, in addition to any other debt incurred beyond that, would go up significantly if there was a credit downgrade. Transcript at 159.

An equity infusion would have fared little better. The Company would seek the infusion from its parent who would have been asked to go without any cash return for an indeterminate amount of time. Transcript at 167. This would pose an unattractive situation for current and prospective shareholders.

In sum, given the small size of this Company, and the large cost of the asset under consideration, it is not only financially imprudent, but unfeasible for this Company to acquire BMGS without the Commission pre-approving rate base treatment. This really comes down to a regulatory lag issue. Regulatory lag is a common complaint of utilities. It is often cited as the reason why a utility cannot earn its rate of return and suffers from earnings erosion. The problem with this argument is that regulatory lag cuts both ways. It often benefits the utility and in those instances, the utility is never heard to complain. However, here regulatory lag not only hurts the shareholders, it hurts the ratepayers. And just as importantly, making an exception here does not harm anyone.

The acquisition of BMGS will benefit ratepayers. The Company purchases 50 percent of its power through PPAs. UNSE-8 at 6. The majority of the rest of its generation it acquires from BMGS through its PPA with UED and a small amount, 65 MW, from its Valencia Turbine. Id. If the Company acquires BMGS, it will more than double the portion of its peak requirements that it meets with its own capacity. RUCO-6 at 18. According to the Company as well as Dr. Johnson, ownership will provide the Company with more flexibility, reliability, efficiency and a superior location--all of which benefits its ratepayers. Id., UNSE-8 at 17.

> Ownership also allows UNSE to address the "intermittency issues of certain types of renewable energy facilities that will be providing power to UNS Electric customers in the future." [Id., p. 18]
>
> Ownership increases reliability, because the Company will have "complete discretion and control over maintenance and operation of the facility for the long term." [Id.] Owning BMGS increases efficiency, by allowing UNSE to "obtain the exact type of unit it needs to meet its requirements" and "better meet its peaking capacity and reserve needs of its supply portfolio on a long-term basis". [Id.] Finally, "because BMGS is located in UNS Electric's load area, it can help to minimize transmission costs and enhance system reliability". [Id.]

RUCO-6, at 18, UNSE-18 at 17.

The Company has very little generation in its resource mix and the acquisition of BMGS will significantly improve its resource portfolio, making it less subject to the uncertainty associated with the wholesale market. RUCO-6 at 18-19. A better resource mix will improve the Company's business risk profile which will be beneficial to the Company's credit outlook in the long term. RUCO-6 at 20. An improved credit rating could result in a lower cost of debt which equates to lower rates for ratepayers. Moreover, the purchase price is reasonable. Id. at 19. The turbines were 2003 vintage models that were never placed in service and purchased for 50 percent less than purchasing two new turbines of this model from the manufacturer. Id. There is no question that ratepayers would be getting the benefit of a good deal should the Company make the acquisition.

The Company's ratepayers would lose a good opportunity here if the Company does not acquire BMGS. Furthermore, the ratepayer would not be harmed by pre-approved rate base treatment. The Company has shown that pre-approval would not result in a rate increase to the ratepayers. The rate reclassification that the Commission would approve would have a neutral effect on the ratepayer's rates. On average, the acquisition would result in "…7 mils coming out of the purchased power and fuel rates and 7 mils roughly, an equal amount going into the nonfuel base rate." Transcript at 154.

When asked on cross examination what would be the harm of pre-approval in this case, Staff's witness, Dr. Thomas H. Fish responded: "The direct harm. I don't know that there would be any serious direct harm. There could well be a precedent set that it is premature at best[2]." Transcript at 453-454. This "indirect harm" is easy to rectify--the Commission need only note in its Decision the unusual situation here and that this ratemaking treatment is not intended to establish precedent.

There is no harm to ratepayers of any consequence by pre-approving the ratemaking treatment of the BMGS in this case. The real harm will be suffered by ratepayers if the Commission does not pre-approve the ratemaking treatment and the Company does not acquire the plant which it is not likely to do absent pre-approval.

RELIEF REQUESTED: The Commission should approve the Company's request that the Commission approve a post-test year adjustment to the Company's fair value rate base of $63,375,676 million for the BMGS and a revenue neutral rate reclassification reflective of the cost of the BMGS. RUCO-6 at 18. Final Schedule at BJ-3 and BJ-5.

Post Test Year Non-Revenue Plant in Service

The Company proposes to include 85 items in rate base that were not in service at the end of the test year. RUCO-6 at 22. The Company claims that these investments will be in service when the new rates resulting from this case go into effect. UNSE-15 at 12. These investments, as the Company asserts, should improve the Company's reliability. RUCO-6 at 25, Transcript at 312. These investments should also help the Company's efficiency and help

---

[2] Dr. Fish did expand on his answer and on redirect by his counsel added that there is a remote chance of harm if it "…turns out that preapproval is associated with the financing…" Transcript at 494. This additional harm, by Dr. Fish's admission is remote and does not appear to be significant.

to reduce costs. (i.e. projects to replace existing work order, facilities data base and facilities mapping system with improved GPS based work order and mapping system). RUCO-6 at 25. None of the efficiencies or the reduction to operating costs, however, are reflected in the Company's proposed adjustment. Transcript at 313. Nor are the revenues reflected in the Company's proposal that will accommodate the growth that will result from the completion of these projects. RUCO-6 at 26. The approval of these post test year investments violates the matching principle. Id. The Company has not shown anything extraordinary about these investments and/or why the Commission should violate a standard accounting principle that will result in higher rates. The Commission should reject the Company's request to include the post test year investments.

RUCO does not question the prudency of these investments. RUCO-6 at 25. The question is whether these routine, ordinary type investments require extra-ordinary post-test-year adjustments. As mentioned above, it is not appropriate or fair to ratepayers to modify the test year for some, but not all of the impacts of post test year events. Id. at 26. Moreover, the Company will ultimately receive reimbursement for the investments from its ratepayers through the allowance for depreciation in existing rates, the revenue growth from increases in the sale of energy to existing and new customers and the reduction in operating expenses resulting form the investments. Id. at 25. Finally, it is good public policy to continue to base rates on the historical test year and not on post test year investments that will hopefully be completed and in use at the time new rates go into effect. Id. at 25-26.

RELIEF REQUESTED: The Commission should reject the Company's request to include $7,263,614 of post test year plant in rate base. RUCO-6 at 22, Issue Matrix at 3, Final Schedule at BJ-3 and BJ-5.

III. CONTESTED INCOME ADJUSTMENTS

Payroll Expense

The Company's adjustment which increases its operating expenses by $220,252 used end of test year employee levels and included the 2009 and estimated 2010 pay rate increase.[3] RUCO-6 at 33, UNSE-15 at 20-21. RUCO does not object to the 2009 increase since it helps synchronize the payroll expense with other aspects of the test year calculations. RUCO-6 at 33. RUCO does oppose the pay increase for 2010. That pay increase went into effect over one year beyond the test year. Even the Company admits the Commission should use its judgment when determining what is reasonable. Transcript at 314. When the Commission allows utilities to recover payroll expense attributable to raises over one year beyond the test year, one has to ask what is the point of even having a historical test year? What makes the 2010 raise any different than a 2011 increase?

The point is even further compounded by the state of the current economy. For those ratepayers that even have a job, and with current unemployment at or around 10 percent, allowing rates to increase to account for a Company wide raise that is over one year beyond the test year is simply inappropriate. RUCO recommends the Commission allow the 2009 post test year raise but reject the 2010 raise.

RELIEF REQUESTED: The Commission should modify the Company's adjustment to allow for an increase of $79,628 to operating expenses for payroll expense. RUCO-6 at 34, Final Schedule BJ-7 at 1.

---

[3] At the time the Company presented its Direct case the rate increase was an estimate. However the rate increase went into effect in January 2010 so it is now known. Transcript at 314.

Payroll Tax Expense

RUCO modified the Company's payroll tax adjustment to be consistent with RUCO's modifications to payroll expense adjustment addressed above.

RELIEF REQUESTED: The Commission should modify the Company's adjustment to allow for an increase of $35,430 to operating expenses for payroll tax expense. RUCO-6 at 34, Final Schedule BJ-7 at 2.

Property Tax Adjustment

The Company and RUCO disagree with the proper assessment ratio for calculating property tax expense. The Company has proposed using the assessment ratio that goes into effect January 1, 2010 and RUCO recommends using the assessment ratio that went into effect on January 1, 2009. RUCO-7 at 7. RUCO's recommendation is reasonable and consistent with the application of a historical test year. Id. RUCO does understand that there is a long lag in the property taxation process and concedes that this is a "close call" but believes it better to side on the approach that is consistent with the historical test year principal.

RELIEF REQUESTED: The Commission should adopt RUCO's adjustment to property taxes and decrease the Company's operating expenses by $ 7,358 for property tax expense. RUCO-6 at 42, Issue Matrix at 10. Final Schedule BJ- 7 at 3.

Rate Case Expense

The Company requests rate case expense of $500,000, to be amortized over 3 years for an annualized expense of $166,667. RUCO-6 at 36. The Company then adds $30,556 as the remaining amount of rate case expense approved in the last rate case expense, and subtracts $58,333 as the amount of rate case expense approved in the last rate case which has already been collected during the test year. Id. The net result is the $138,890 decrease in operating income referenced in the joint Issue Matrix. Id., Issue Matrix at 6. RUCO, on the other hand recommends recovery of $300,000 annualized over three years which results in a $72,223 increase to operating expenses. RUCO-6 at 36.

In its last rate case, the Company requested $600,000 in rate case expense amortized over three years and was awarded $300,000 amortized over three years. Decision No. 70360 at 23. In its last rate case, the Commission noted that it was similar to the then recent Southwest Gas case and that the rate case expense in the Southwest Gas case was an appropriate measure. In the Southwest Gas case, the Commission awarded $235,000 but the Commission felt that UNSE was entitled to more since it was the first case since its acquisition and there was an abnormally high amount of discovery. Id. at 24.

This case has similar characteristics to the cases mentioned above. This case was filed two years after the Company's last rate case was decided.. RUCO-6 at 36. The majority of each application process was performed by in-house staff or affiliated company staff. Id. The length of the hearings in each proceeding was similar. Perhaps one notable difference was in the Southwest Gas case the Company proposed a full decoupling rate design which was highly contentious. Rate design is not nearly as contentious in this case. In all, the Company's rate expense request is excessive and should be reduced as recommended by RUCO.

RELIEF REQUESTED: The Commission should allow the Company rate case expense totaling $300,000 amortized over three years which results in a $72,223 increase to operating expenses. Final Schedule BJ-7 at 2.

Miscellaneous Expenses

RUCO disagrees with the Company's adjustment concerning the industry association dues. RUCO recommends disallowance of 40 percent of the Company's EEI dues (the Company disallowed 16 percent). RUCO, consistent with its position on this matter in the past believes that an indeterminate portion of EEI activities are designed to directly and indirectly influence government policy. RUCO-6 at 39. This purpose does not benefit the ratepayers but does provide benefit to the shareholders. Id. at 40.

It is also difficult to say that these types of organizations are necessary to provide for the provision of service as they would still continue in the absence of the Company's membership. Id. RUCO recognizes that there is some benefit here, but believes the ratepayers should not have to pay for any more than 60 percent of the costs. Id.

Another miscellaneous expense includes postage expenses. The Company included the portion of expense related to the May 2009 postage increase. Since the May 2009 increase is five months beyond the test year, RUCO excluded that portion of the expense related to the post test-year increase.

Finally, the Company normalized outside legal expenses. The Company's calculation considered the expenses incurred in a three year period that excluded the test year. RUCO-6 at 40. RUCO recommends the Commission normalize the expense for the three years of 2006, 2007 and 2008, and exclude the legal expenses associated with the prior rate case. Id.

RELIEF REQUESTED: The Commission should reject the Company's request to include $407,957 of miscellaneous expense. RUCO-6 at Schedule B-J-7, page 2, Issue Matrix at 8, Final Schedule BJ-7 at 2.

Depreciation and Property Tax for Post test year non-revenue producing plant in service.

The Company's adjustment lacks support but it appears to be related to the "non-revenue producing" plant investment that the Company proposes to add to rate base. Id. This plant was not in service during the test year which is why RUCO disallowed it – see above. Id. Accordingly, the depreciation and property tax associated with it should be disallowed.

RELIEF REQUESTED: The Commission should disallow the depreciation and property tax associated with the post test year non-revenue producing plant. RUCO-6 at 41, Issue Matrix at 9, Final Schedule BJ-7 at 3.

Incentive Compensation-Performance Enhancement Program ("PEP"), SERP, and income tax related to disallowed incentive compensation.

The Company's non-union employees participate in an incentive compensation plan designed to award them for their contributions to the Company. UNSE-15 at 16. The plan is comprised of elements that relate to the Company's financial goals and cost containment goals. Id. at 17. The Company's achievement of these performance targets benefits both ratepayers and stockholders; however, the Company proposes that the ratepayers, and not the shareholders should pay for the costs of the plan. Id. at 15-20. For these reasons, as well as the following, RUCO recommends the Commission disallow 50 percent of the incentive compensation, and 100 percent of the stock-based and SERP compensation. RUCO—6 at 43-44. The Company's payroll expense associated with theses costs should be adjusted accordingly. Id., Issue Matrix at 10.

This issue, similar to the stock based compensation and the SERP issues, has been raised by numerous utilities before this Commission for a long time. As in the case here, there really are no new arguments, just a rehash of the same old arguments. The Company continues to disagree in its evaluation as to who benefits from incentive compensation. In the last UNS Gas rate case, the Commission determined that a 50 percent sharing in a similar program (the Company's Performance Enhancement Program) provides a rebalancing of the interests between ratepayers and shareholders by requiring each group to bear half the costs of the incentive program. Decision No. 70011 at 27. In the last UNS Electric rate case, the Commission made the exact same award and applied the exact same reasoning (citing the last UNS Gas rate case) regarding the incentive program[4]. Decision No. 70360 at 21. In UNS Electric, the Commission further noted "Given that the arguments raised in the UNS Gas case are virtually identical to those presented in this case; we see no reason to deviate from that recent Decision." Id. The same should hold true here.

The Commission denied the Company's request for stock-based compensation in the Company's last rate case. Decision No. 70360 at 22. The Commission concluded:

> As Staff witness Ralph Smith stated, the expense of providing stock options and other stock-based compensation beyond normal levels of compensation should be borne by shareholders rather than ratepayers (Ex. S-58, at 34). The disallowance of stock-based compensation is consistent with the most recent rate case for Arizona Public Service Company (Decision No. 69663).

Decision No. 70360 at 22. There is nothing new in this case, and the Commission should not change its well-reasoned precedent absent a compelling reason.

The Commission should give the same consideration to the Company's SERP proposal. UNSE offers a SERP to a select group of high-ranking officers in the Company, in addition to their regular retirement plan. UNS-16 at 20. These executives are already fairly compensated

---

[4] Presently, UNS Gas has a pending rate application. The matter is presently scheduled for the March Open Meeting and a Recommended Opinion and Order ("ROO") has been issued. The ROO recommends disallowance of UNS Gas' Officer's Long-Term Incentive Program and 100 percent of the SERP costs. UNS Gas ROO at 20-22.

for their work, and are provided a wide array of benefits. The additional costs of a second retirement plan for executives are not essential for the provision of electric service to customers, and should be borne by shareholders, not customers.

Nonetheless, the Company still maintains that the Commission should require ratepayers to pay for the cost of its SERP. UNSE-17 at 21. There has been a plethora of recent cases where the Commission has disallowed expenses related to SERP. The reason is the same – the Commission has made it clear that it does not believe that it is reasonable for ratepayers to pay for additional compensation to the utilities' highest paid employees to remedy what the utility perceives as a deficiency in retirement benefits relative to the utilities' other employees. See UNS Gas' last rate case (Decision No. 70011 at 28-29), Southwest Gas' last rate case (Decision No. 70665 at 17-18 December 24, 2008), Southwest Gas' prior rate case (Decision No. 68487 at 17-18, February 23, 2006), and the Company's last rate case (Decision No. 70360 at 22, May 27, 2008). Once again, there is nothing new in this case, and the Commission should not change its well-reasoned precedent absent a compelling reason.

RELIEF REQUESTED: The Commission should reject the Company's request for the recovery of stock based incentives, SERP expenses and provide for a 50/50 sharing of incentive compensation and make the corresponding reductions to payroll tax expense. Issue Matrix at 10, RUCO-6 at 43-44.

90/10 Sharing of the costs associated with purchased power and fuel

RUCO recommends a 90/10 sharing mechanism for the Company for the costs associated with purchased power and fuel. RUCO-6 at 44. Historically, the Company has acquired nearly all of its energy from APS so there was not a great need for an incentive mechanism. Id. However, the Company plans on purchasing more power on the wholesale market so an incentive mechanism would now be appropriate.

The purpose of the 90/10 sharing is to provide UNSE an incentive to minimize total fuel and purchase power costs, including maximizing the margin from off-system sales. A mechanism to create such an incentive is critical to a PPFAC, because if customers are responsible to pay for all fuel costs, the utility would not otherwise have any incentive to minimize those costs.

RELIEF REQUESTED: RUCO recommends the Commission approve a 90/10 sharing mechanism for the Company's purchased power and fuel related costs. Id.

Synchronized Interest

This is a corresponding adjustment to income tax to synchronize interest.

RELIEF REQUESTED: RUCO recommends an interest synchronization adjustment of $93,459. Final Schedule BJ-7 at 3.

IV. RATE DESIGN

The main difference between RUCO and the Company's rate design has to do with the standard and Time of Use ("TOU") rates each party recommends. The current residential monthly charge for residential customers is $7.50. RUCO-7 at 22. RUCO is recommending a reduction in the residential monthly charge to $5.00 and the Company is recommending an increase in the charge to $8.00. RUCO-8 at 8. RUCO contends that the current $7.50 customer charge is higher than appropriate. Id. at 8-9.

Of course, there is a quid pro quo with RUCO's recommendation. RUCO recommends rate block structure applying the lowest energy rate to the first 400 kWh per month; and charging a higher rate for the next 400 kWh per month, and charging a still higher rate for all additional kWh. Id., RUCO-10 at 33. The focus of RUCO's recommendation is energy conservation which rewards lower energy users with lower bills.

The Company claims that RUCO's proposal would "radically" shift cost recovery away from the customer charge to the energy charge and prevent the Company from earning its return because certain costs "will go unrecovered if kWh sales levels are below the test-year levels used to design rates." Id. UNS-19 at 6-7. However, in making that claim, the Company significantly understates the residential customer charge. Id. Moreover, even the Company admits that RUCO's proposed rate design will provide customers a greater incentive to conserve energy. UNS-19 at 7.

RUCO believes that the Company's concerns regarding its inability to earn its return are unfounded. The current residential customer charges are already higher than appropriate and the Company's proposal to increase this charge is not based upon a valid economic analysis of costs. RUCO-8 at 8-9. The Company's proposal is based on an embedded cost allocation approach which allocates substantial portions of the Company's distribution investment and operating expenses on the basis of customers, regardless of whether or not these items directly vary in response to decisions by customers to join or leave the system. Id. Most of the costs allocated to this rate are not focused on the variable costs that are directly attributable to the decision of customers to join or leave the system, and there are no computations based on a forward looking, marginal cost analysis. Id.

The customer charge should primarily collect the variable costs of metering, billing, and collecting the monthly bill. Other costs, such as costs of the distribution system, do not vary from month to month. Id. These other costs change with the number of customers on the system, and it is reasonable to recover these costs through the service that is sold to consumers. Id.

Finally, setting customer charges at relatively high levels encourages kWh consumption and discourages energy conservation – both of which are contrary to the public interest and good public policy. Id. Although the Company's inclining block rate structure ameliorates part of this problem, it does not completely eliminate it. Id. The high customer charges proposed by the Company tend to result in customer bills that decrease on a per-total-kWh basis as usage increases, despite the inclining block structure. Id. By proposing to further increase customer charges above levels which are already higher than necessary, the Company is proposing to place an even heavier burden on low use customers and losing an opportunity to encourage energy conservation.

RELIEF REQUESTED: RUCO recommends the Commission approve RUCO's proposed rate design. Final Schedule BJ-11 – BJ-13.

V. FAIR VALUE RATE OF RETURN

RUCO recommends a fair value rate of return ("FVROR") of 5.96 percent which is both fair and reasonable under the circumstances of this case. RUCO-6 at 58. RUCO considered five methodologies used and/or considered in other rate cases before the Commission since the Court of Appeals ruled on this issue and remanded the case back to the Commission for consideration in Chaparral. RCUO-6. at 57. RUCO considered using the 9.25 percent cost of equity and other WACC inputs and subtracting an inflation rate of 2.1percent from the equity **<u>and</u>** debt components of the capital structure. Id., Schedule BJ-10. The result of this methodology produced a fair value return of 5.96 percent. Id. The second methodology RUCO considered reduced the inflation rate from only the equity component of the capital structure and resulted in a FVROR of 7.1 percent.

The three other approaches have been proposed by Staff in other rate cases and resulted in FVRORs of 5.39 percent, 5.80 percent and 7.01 percent. Id. at 57-58. In sum, comparing the five approaches, the range of returns went from a low of 5.39 percent to a high of 7.10 percent with an average of 6.25 percent. RUCO-11, Schedule BJ-10. RUCO believes the greatest weight should be given to the first approach since theoretically it is the soundest approach. Id.

Similar to its practice in determining cost of equity, RUCO considered the range that resulted from the five calculations. RUCO recognized that the determination of the FVROR is not an exact science and, at best, an estimation. Id. The estimation, however, must have reasonable basis in order to derive a result that is both fair to the Company and fair to the ratepayer. Of course, the current state of the economy, as bad as it is, must also be factored into the equation. RUCO based its recommendation on how the FVROR has been developed since the recent Court of Appeals decision in the Chaparral case, the current economy and what makes sense and is fair and reasonable under the circumstances of this case. Id. RUCO used its best judgment in recommending what it believes would be in the Commission's discretion a fair and reasonable rate of return in this matter.

In response, the Company argues that if rate of return is reduced to reflect the impact of inflation, only half the actual rate of inflation should be subtracted from the rate of return, since half the FVRB (The OCRB portion) does not include inflation. RUCO-8 at 2. This argument lacks merit. The fact that OCRB is part of the fair value process does not provide an adequate justification for slashing the inflation rate in half. Id. At 2-3. It is true that ORCB is given half weight in developing the FVRB, and OCRB does not increase with inflation. However, half weight is also being given to RCND, and reproduction costs tend to grow faster than the actual rate of inflation. Id. RCND does not fully consider the favorable impact of technological changes, increasing economies of scale, the beneficial impact of making input substitutions to increase reliance on inputs that are decreasing in cost, have been more favorably affected by technological change, or have experienced relatively mild increases in price levels. Id.

These factors are taken into consideration in developing inflation statistics, and thus the rate of inflation that is reported for the Consumer Price Index, the GDP Deflator, and similar data series reflects the beneficial (ameliorating) impact of these phenomena – whereas RCND has a tendency to grow faster than the overall rate of inflation, because these ameliorating factors are not adequately reflected in the development of reproduction costs. Id.

The failure to account for the RCND estimation efficiencies and costs savings associated with technological advances weighs strongly against a clear cut halving of the inflation rate. The administrative law judge in the pending UNS Gas case recognized the flaw in such a proposal:

> In the Chaparral City Rate Case, we found that an inflation element exists in both the debt and equity components of the capital structure and, accordingly, the inflation adjustment should be made to the entire cost of capital. (Decision No. 71308, at 45.) In that Decision, we reiterated that "the most basic tenet of rate regulation … is that a utility should be provided with rates that will allow it an opportunity to earn a return that is comparable to those of similarly situated enterprises."[22] However, we do not believe the inflation factor should be reduced by 50 percent, as was done in that case, because such a methodology would fail to recognize that RCND estimations are based on estimates of the cost to reconstruct the entirety of the Company's system at current prices, and do not take into account in the RCND estimation efficiencies and cost savings that may exist due to factors such as technological advances. We note that the Chaparral City Remand Decision did not apply a 50 percent weighting factor to the inflation estimate, although inflation was calculated only on the equity component in that case due to a lack of sufficient evidence in the record concerning inflation in the cost of debt. (Decision No. 70441, at 36-37.) In this proceeding, we find that an unadjusted inflation factor should be subtracted from the entire WACC, to afford appropriate recognition to

---

[22] Id. at 48 citing *Federal power Comm'n v. Hope Natural Gas*, 320 U.S. 591, 64 S. CT 281 (1944)

> the fact that inflation exists in both the debt and equity components of the Company's capital structure, and that reconstruction cost estimates likely exceed the rate of inflation based on the factors cited above.

UNS Gas ROO at 50. Likewise, in the subject case the Commission should find that an unadjusted inflation factor should be subtracted from the entire WACC, to afford appropriate recognition that inflation exists in both the debt and equity components of the Company's capital structure, and that the RCND costs estimates likely exceed the rate of inflation.

RUCO recommends the Commission subtract an inflation factor of 2.10 percent from the debt and equity component of the Company's capital structure. RUCO-6, Schedule BJ-10. RUCO's recommendation is conservative which is also supported by Judge Nodes' recommendation in UNS Gas:

> We turn next to the appropriate inflation rate to be applied to UNS Gas's WACC. In his direct testimony, Company witness Grant indicated that an inflation factor of 2.9 percent was appropriate for purposes of supporting a justification of a 7.30 percent FVROR. (Ex. A-13, at 30-31.) In his direct testimony, RUCO witness William Rigsby calculated an average inflation factor of 2.5 percent for the years 2001 through 2008, a level of inflation that RUCO witness Smith found to be "a very conservative estimate of inflation." (Ex. R-13, Sched. WAR-1, p.4; Ex. R-21, at 10.) Staff witness David Parcell suggested that an inflation factor of 2.0 percent should be used for calculating the FVROR, if Staffs alternative recommendation is adopted by the Commission. (Ex. S-14, at 50.)
>
> Although we believe it would be reasonable to assume an inflation factor as high as 2.9 percent, as suggested in the Company's direct testimony, for purposes of determining an appropriate FVROR in this case we will adopt a lower inflation rate based on an average of the Staff and RUCO inflation rates. The average of the Staff and RUCO rates of 2.0 and 2.5 percent, respectively, results in a rate of 2.25 percent, which we believe is a conservative estimate of the inflation factor that should be applied to the WACC in order to remove from it the effects of inflation. Subtracting the 2.25 percent inflation factor from the 8.0 percent WACC, results in a FVROR of 5.75 percent, which we find to be reasonable under the facts and circumstances of this case. Applying the FVROR to the FVRB determined herein, produces an overall revenue increase of $3,245,607.

UNS Gas ROO at 50-51. The ROO is currently pending – the inflation estimates are not stale and should be just as applicable in this case. A 2.10 percent inflation factor is not only conservative but very reasonable to the Company and its ratepayers. The Commission should adopt RUCO's FVROR recommendation.

FVRB reflects the Commission's estimate of the current fair value of the utility's property and equipment; if the Commission were to rely exclusively on RCND, it would greatly overstate the current value, which would not be fair to consumers. Id. There is no logical reason to slash the inflation rate in half – much less adopt a rule that mandates this approach in all cases, regardless of the underlying factual circumstances (e.g. the manner in which the RCND estimates were developed, or the extent to which those estimates have been growing at a pace that is faster than the overall rate of inflation). Id.

RELIEF REQUESTED: The Commission should adopt RUCO's 5.96 percent FVROR. Final Schedule BJ-1, BJ-10.

VI. COST OF CAPITAL

Capital Structure

RUCO and the Company agree on the Company's proposed capital structure of 54.24 percent debt and 45.76 percent equity. RUCO-11 at 3.

Cost of Debt

The Company proposes a 7.05 percent cost of debt, to which RUCO agrees. Id. at 3.

Cost of Equity

UNSE proposes a return on equity of 11.40 percent. Id. at 4. Staff's proposed cost of equity is 10.00 percent. Id. RUCO's proposed return on equity is 9.25 percent. Id. All of the parties based their proposals on results obtained from the Discounted Cash Flow Model (("DCF") RUCO, Staff, and Company) and/or the Capital Asset Pricing Model (("CAPM") RUCO, Staff, Company) and/or the bond yield plus risk premium (Company) and/or Comparable Earnings model (Staff). Id. at 4-23, UNSE-22 at 7-17, and S-14 at 25-37.

RUCO believes that its approach to calculating the return on equity results in the most reasonable return on equity recommendation under the facts and circumstances of this case. There are important differences in the approaches RUCO and the Company took to implementing the models, producing their differing results. First, the Company utilized a multi-stage DCF analysis, where RUCO used a single-stage analysis. Company witness Pritz believes that the multi-stage model is appropriate since the short-term growth estimates do not extend beyond five years. UNSE-22 at 8. The Company believes that this change in growth rates necessitates the use of the multi-stage model. Id.

RUCO's witness, Bill Rigsby, used a single-stage model that already takes into consideration both short-term and long-term (i.e. growth projections that are specific to the local distribution companies ("LDC") used in Mr. Rigsby's proxy). RUCO-11 at 53-54. The long-term growth rate referred to by Mrs. Pritz, which was used in her multi-stage DCF model, assumes a long-term growth rate for LDCs that will be very close to an inflation-adjusted growth rate of the entire US economy into perpetuity. RUCO-11 at 21. This assumption that utility long-term growth rates will closely mirror national Gross Domestic Product growth into perpetuity is suspect. Id.

Furthermore, as pointed out in the surrebuttal testimony of Mr. Rigsby, FERC requires that the growth components of the multi-stage model be weighted in such a way that more emphasis is placed on the short-term (i.e. 5-year estimates) as opposed to long-term estimates that are calculated into perpetuity. Id. at 22. The rationale for the FERC's weighting requirement is "that short-term growth rates are more predictable, and thus deserve a higher weighting than long term growth rate projections." Id. Thus the FERC places more weight on the growth estimates used by Mr. Rigsby in his constant growth DCF model.

Using Mrs. Pritz inputs and estimates, a single-stage model would produce a mean average estimate of 11.40 percent, which is 185 basis points higher than Mr. Rigsby's 9.95 percent estimate. RUCO-10 at 55.

Second, the witnesses used a different proxy for the market rate of return in their CAPM analyses. Mr. Rigsby used both geometric and arithmetic means of historical returns. Id. at 59. Mrs. Pritz relied solely on the arithmetic mean of historical returns as the proxy for the market rate of return. Id. Information on both the geometric and arithmetic means is widely available to the investment community, and it is therefore appropriate to use both means in CAPM analysis. Id., RUCO-11 at 8. Further, the geometric mean provides a truer picture of the effects of compounding on the value of an investment when return variability exists, and therefore it is an important metric to include. Id.

It is not uncommon for RUCO and the Staff to also differ in their approach to cost of equity. However, RUCO's approach, as will be more fully explained, is more sensitive to the current economic environment. Staff's witness, David Parcell utilized three methodologies in calculating Staff's return on equity recommendation. S-14 at 38. Parcell's methodologies produced the following results:

Discounted Cash Flow	9.4-10.1 percent
Capital Asset Pricing Model	7.6-8.3 percent
Comparable Earnings	9.5-10.5 percent

Id. Mr. Parcell recommended a cost of equity of 9.5 percent to 10.5 percent for the Company. Id. This reflected the ranges of his DCF and Comparable Earnings Models. Id. Within the range, Mr. Parcell recommended a 10.0 percent level, which is the same level of equity approved by the Commission in the Company's last rate case. Decision No. 70360 at 44. Mr. Parcell's CAPM analysis **was not** reflected in his range of recommendations for Staff's return on equity.

Mr. Parcell admitted that CAPM is frequently used as a check for the DCF analysis. Transcript at 774-775. In this case, Mr. Parcell's CAPM analysis would clearly indicate that the DCF range of 9.5-10.5 percent would be too high. Nonetheless, Mr. Parcell gave consideration to his CAPM results but did not average the results of his CAPM analysis in his final cost of equity recommendation. Transcript at 774. Mr. Parcell attributes the low CAPM results in large part to the decline in the economy, low yields on US Treasury bonds, and the lower risk premium which reflects the decline in stock prices. S-14 at 39. The result is higher priced Treasury securities and lower yields which in turn, lowered the risk-free rate in the CAPM which produced lower than normal CAPM results. Id.

Not surprisingly, RUCO's CAPM results were also low – 5.46-6.83 percent. RUCO-10 at 32. RUCO, however, did not disregard its CAPM results. Mr. Parcell apparently began disregarding the results of his CAPM calculations in other cases before this Commission when the financial markets went into turmoil. RUCO-12 at 833. While there is a certain sense of logic to Mr. Parcell's dismissal of the CAPM now, it begs the question what is a normal economy? Staff has not disregarded the CAPM results in other cases when the economy was on an upswing and the results were undoubtedly high. So when then, should the CAPM stop being a check to the DCF analysis?

According to Mr. Parcell, the current economic conditions influence the inputs for the CAPM model. Id. at 834. Likewise, economic conditions also affect the inputs in the DCF model through the dividend yield and growth rates. Id. Mr. Parcell testified that if the Commission were inclined to consider the economy in its deliberations, the way to do it would be through the cost of capital rather than the revenue requirement. Transcript at 780-782. So for example, Mr. Parcell testified that if the Commission were inclined to give specific consideration to the economic conditions, the Commission could move to the low end of the witnesses cost of capital range[5]. Id.

In general, this Commission has made it clear that the current state of the economy and the impact on ratepayers that will result from a rate increase is a priority. The Commission is focused on the impact of the economy on ratepayers and, at the very least should focus on the low end of the cost of capital range.

RELIEF REQUESTED: The Commission should adopt RUCO's 9.25 percent return on equity and 5.96 percent fair value rate of return. RUCO-11 at 5. Final Schedule BJ-7 at WAR-1, BJ-1.

VII. ISSUES WHERE THERE IS AGREEMENT BETWEEN RUCO AND THE COMPANY AND OTHER ISSUES WHICH RUCO HAS NOT TAKEN A POSITION

RUCO and the Company have reached agreement on several issues that were originally in dispute or simply have not taken a position on. Those issues are:

---

[5] Judge Nodes, in the pending UNS Gas ROO, felt it appropriate for the Commission to go to the "low end" of Staff's range in that case, and is recommending the adoption of a 9.50 percent cost of equity in that case. UNS Gas ROO at 42-43.

- Rate Base –Unadjusted Original Cost Rate Base (OCRB), Acquisition Discount Adjustment, Accumulated Deferred Income Tax, Black Mountain Plant in Service, Issue Matrix at 3,
- Operating Income Adjustments – Original unadjusted operating income, retail revenue and purchased power annualization (RUCO-6 at 28), wholesale revenue and purchased power (RUCO-6 at 28), weather normalization (RUCO-6 at 30), customer energy and demand normalization (RUCO-6 at 30), fuel and PPFAC revenue and expense normalization (RUCO-6 at 31-32), cares discount (RUCO-6 at 32), DSM and renewables revenue and expense. (RUCO-6 at 32-33), Issue Matrix at 4,
- Operating Expense Adjustments – pension and benefits, post-retirement medical, bad debt expense, interest on customer deposits, workers compensation, A&G expense capitalized, depreciation and amortization expense annualization, wholesale credit support, fleet fuel expense, call center expense, BMGS PPA adjustment, O&M expense, and depreciation and amortization annualization expense. Issue Matrix at 5-12.
- Capital Structure – RUCO, Staff and the Company agree on the Company's proposed capital structure of 54.24 percent debt and 45.76 percent equity. RUCO-11 at 3, Issue Matrix at 1.
- Cost of Debt - RUCO, Staff and the Company agree on the Company's proposed cost of Debt of 7.05 percent. RUCO-11 at 3, Issue Matrix at 1.
- Other issues that RUCO did not take a position – rules and regulations and changes in rules and regulations, independent fuel and purchase power audit, listing worst

performing distribution circuits in annual report, thermal scanning and school programs for energy efficiency, TOU and renewables. Issue Matrix at 13-14.

VIII. CONCLUSION

RUCO recommends that the Commission approve a revenue increase of no more than $4,604,908**,** based on the above discussion and as reflected in its final schedules. The Commission should adopt RUCO's 9.25 percent return on equity and 5.96 percent FVROR. Further, RUCO recommends that the Commission adopt RUCO's rate design that will reduce the residential ratepayer's basic service charge from $7.50 per month to $5.00 per month.

RESPECTFULLY SUBMITTED this 23rd day of March, 2010.

____
Daniel W. Pozefsky
Chief Counsel

AN ORIGINAL AND THIRTEEN COPIES
of the foregoing filed this 23rd day
of March, 2010 with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

COPIES of the foregoing hand delivered/
mailed this 23rd day of March, 2010 to:

Jane L. Rodda
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Janice Alward, Chief Counsel
Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Steven M. Olea, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Michael W. Patten
Roshka, DeWulf & Patten PLC
One Arizona Center
400 E. Van Buren, Suite 800
Phoenix, AZ 85004

Philip J. Dion
Unisource Energy Corporation
One South Church Avenue
Suite 100
Tucson, AZ 85701

Timothy Hogan
AZ Center for Law in the Public Interest
202 E. McDowell Road, Suite 153
Phoenix, Arizona 85004

By ______________________________